SOLVING KENTUCKY'S FISCAL CRISIS

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If the decision is to increase revenue to the level required to pay for the current level of services that have been promised to the people of Kentucky by specific acts of the General Assembly then all that is needed is the political will: the information about what to do is readily available.

One of the most obvious ways is to eliminate some of the legislatively enacted exemptions from taxes already in place. There are over 200 of these exemptions which reduce the amount of money collected by approximately $6 billion; almost as much as is collected to support Kentucky's General Fund!

These exemptions, officially known as tax expenditures, have been detailed by the Office of State Budget Director in a publication entitled, *Tax Expenditure Analysis*, a biennial publication of the office.

Many other studies have discussed some of these options as well as actually increasing some rates and expanding other sources of revenue such as gaming.

The Patton Administration has been exploring this subject since 2000 and has offered two comprehensive tax reform measures which have generally been ignored by the General Assembly. The longer the problem goes unaddressed the bigger it gets.

Brereton Jones called attention to the problem of an outmoded tax code in 1995. Had the problem been addressed in the right way at that time, we could have had a tax code which is more fair to our poor and working families, which will keep us more equal to our competing states, which will produce more stable revenue and grow with our economy, and would have avoided the crisis we face today; and it could have been revenue neutral.

In 2000 Governor Patton proposed comprehensive tax reform with a modest increase of about $144 million to meet the then-existing commitments of the Commonwealth.

In 2003 he proposed a more expansive reform generating $573 million to close the widening revenue gap which three years of delay had precipitated.

Today the need is greater, about $700 million, not counting the $250 million a year shortfall in the Road Fund.

Governor Patton and his staff have prepared one proposal which would generate these funds. There are, no doubt, many other combinations of reforms which would achieve this end.

The attached “Revenue Modernization Proposal – Plan C” lists this combination of increases and decreases which the Governor recommends as a starting point. In general, each item on this list meets some or all of the desirable tax code characteristics of fairness, competitiveness, stability and growth.

Most of the changes are apparent on their face or described more completely in the appendices but some notable characteristics of the proposal are:

1. Business taxes. These changes are almost revenue neutral but they contribute substantially to fairness, requiring all businesses which enjoy the limited liability granted by state law to pay the same taxes, reducing the opportunity to “game the system” to reduce tax burden. These changes will make our revenue stream from the business community more stable, and will cause it to grow much more closely with our economy. This proposal reverses the ITW court decision and provides for a modified Enterprise Zone extension.
2. Revenue generated by expanding gaming will start low and take about two years to reach full maturity. At that time the new revenue should be adequate (along with growth revenue) to permit the reduction in the sales tax back to six percent. This proposal is to use the expanding gaming proceeds during this start-up period to first pay a bonus, similar to past bonuses paid to Kentucky veterans, to all eligible Kentucky veterans of all our wars since Vietnam and then use the remainder to rebuild our Budget Reserve Trust Fund.
3. The opportunity to rollback the increase in the sales tax will provide an incentive for voters to authorize the expansion of gambling through a constitutional amendment.

Another revenue measure which Governor Patton will ask the Lottery Corporation to implement immediately to adequately fund our KEES, KTG and CAP college scholarship programs and make up for the loss of revenue which will be occasioned by the advent of the Tennessee Lottery is the establishment of a Keno lottery as a part of our existing lottery program. This is the most practicable way to ensure that our current merit and needs-based scholarship programs are more adequately funded.

A recent report of the joint subcommittee of the General Assembly on postsecondary education indicated that in Fiscal Year 2006 the KEES program will be underfunded by $19 million if the practice of placing unclaimed prize money into a KEES reserve account is not continued and the needs-based program could be underfunded by as much as $70 million. The expected proceeds from Keno of $30 million will not solve these problems but it will go a long way towards helping many children stay in college in Kentucky.

Revenue Modernization Proposals
($millions)

	FY 05	FY 06
Comprehensive Tax Reform Measures to Increase Adequacy, Fairness, Growth, and Stability in the Tax Structure		
Business Taxes		
Common Income Apportionment Regardless of Business Type	$ 50.0	$ 50.0
Require Consolidated Reporting of Multi-entity Group Income	$ 10.0	$ 10.0
Update Nexus Standards to Capture Entities With a Business Presence in Kentucky	$ 10.0	$ 10.0
Allow net operating losses (NOL) to be Carried Forward Only	$ 10.0	$ 5.0
Adopt a "Throw-back" Rule to Capture Income Taxed Nowhere	$ 3.0	$ 3.0
Assess License Tax on All Business Entities	$ 29.9	$ 31.3
Permit investment in subsidiaries as a deduction and allow consolidated corporate license tax returns (ITW)	$ (60.3)	$ (54.2)
Lower Top Marginal Corporate Income Tax Rate to 7.25%	$ (34.3)	$ (34.8)
Reform Enterprise Zone Program	$ (17.2)	$ (26.2)
Individual Income Taxes		
Expand Low Income Credit to 100% of Federal Poverty Guidelines	$ (33.2)	$ (35.6)
Phase-out Pension Exclusion at $40,200; permit cap to grow by CPI	$ 78.7	$ 80.3
* Eliminate Deduction of Income Tax Paid to Foreign Countries	$ 3.5	$ 3.6
Property Taxes		
Eliminate State Motor Vehicle and Watercraft Property Tax, effective 1/1/05	$ (43.6)	$ (94.4)
Set and Freeze the State Property Tax Rate on Real Property at $.133 per $100 of Assessed Value, or exclude new property from rate calculations, effective 1/1/04	$ 3.4	$ 7.2
Exempt Intangible Personal Property from State Property Tax, effective 1/1/04	$ (34.7)	$ (36.3)
Sales Taxes		
Impose Sales Tax Responsibility on Dot.com Affiliates of Companies with KY Nexus	$ 6.0	$ 7.0
* Restore Sales Tax to Unbundled Transmission and Distribution of Natural Gas	$ 6.0	$ 7.0
* Extend Limit on Vendor Compensation at $1,500 per reporting period	$ 7.1	$ 7.4
Impose Sales Tax on Selected Discretionary Services	$ 51.0	$ 53.8
Raise Sales Tax Rate to 7.0% and Legalize VLTs, Roll-back Sales Tax to 6.0% in 2 years.	$ 416.2	$ 435.4
Eliminate the sales tax on 'switch access' fees paid by communications companies	$ (26.7)	$ (27.0)
Assess sales tax on Direct Broadcast Satellite (DBS) services (assumes 7% rate)	$ 17.4	$ 18.1
Other Taxes		
Raise the Excise Tax on Cigarettes by $.52 per Pack (to $.55 per Pack)	$ 208.6	$ 208.6
* Extend Limit on Cigarette Tax Vendor Compensation	$ 0.9	$ 0.9
Impose a 13% Excise Tax on Other Tobacco Products	$ 7.6	$ 7.6
Consolidate and Simplify Wholesale Taxation on Alcohol Products	$ -	$ -
Total General Fund Tax Reform Measures	**$ 669.3**	**$ 637.7**

* *These provisions are contained in the current budget bill*

Business Taxes

Proposal: Common income apportionment regardless of business type.

- Businesses that operate in multiple states are able to manipulate the amount of income taxable to Kentucky (and other states) by choosing the type of business organization (Corporation, LLC, LLP, Partnership, etc.).
- Different types of entities apportion their income between states in different ways.
- By ‘managing’ income streams between different entities, taxable income can be minimized or eliminated.

Fiscal Impact

- $50 million annually

Impact on Taxpayers

- Businesses that currently manipulate reported income would pay more tax.
- Businesses would have clearer guidelines on how to report income.

Impact on Competitive Position vs. Other States

- Minimal.

Business Taxes (Continued)

Proposal: Require consolidated reporting of multi-entity group income.

- Businesses that operate different segments of business activity as separate legal entities are able to manipulate the amount of income reported to Kentucky.

- Kentucky allows the business to choose its filing method. This allows income that is 'earned' in Kentucky to be assigned to an entity that is not taxable here.

- By creating an entity within the group that is the primary profit center and locating that entity in a low tax or no tax location, most or all tax can be avoided.

Fiscal Impact

- $10 million annually

Impact on Taxpayers

- Businesses that currently manipulate reported income would pay more tax.

- Businesses would have clearer guidelines on how to report income.

Impact on Competitive Position vs. Other States

- Minimal.

Business Taxes (Continued)

Proposal: Update Nexus standards to capture entities with a business presence in KY.

- Kentucky has a 'physical presence' standard, the only state to use this method of determining nexus.
- Most other states use a 'doing business' or 'deriving income' standard, meaning that the state asserts the business is subject to the state's tax laws if it is doing business in or deriving income from the state.
- An identical business presence in all fifty states may result in the business being taxable in every state that has an income tax, except for Kentucky.

Fiscal Impact

- $10 million annually

Impact on Taxpayers

- Businesses that currently operate within Kentucky but have no physical presence here would pay tax.
- Businesses would have clearer guidelines on how to report income.

Impact on Competitive Position vs. Other States

- Kentucky would be adopting standards in place in most other states.

Business Taxes (Continued)

Proposal: Allow net operating losses (NOL) to carry forward only.

- Kentucky currently allows businesses to carry-back business NOL's to recoup income taxes paid in prior years.
- If NOL's are deductible only in future years, there is a significant reduction in the volatility of the business tax.
- If NOL's are deductible only in future years, businesses are still afforded the benefit of the deduction, but only in future years.

Fiscal Impact

- $10 million first full year, $5 million second, approximately $1 million annually thereafter.

Impact on Taxpayers

- Businesses that incur an NOL would not recoup previously paid taxes as quickly.

Impact on Competitive Position vs. Other States

- Minimal. Most businesses don't choose to locate in a state based on how their losses are treated.

Proposal: Adopt a ‘Throw-back’ rule to capture income taxed nowhere.

- Multi-state businesses often have income that will be taxable in one state and not taxable in another solely because of legal or statutory differences. This is often referred to as ‘nowhere income’.

- Implementation of a rule that adds these sales back to the numerator of the apportionment factor for sales (throw-back) for a business that is incorporated within the state, results in ‘nowhere income’ being taxed to the home state of the business.

- This is a rule that is more important for states with significant corporate/business headquarters. It is an often overlooked consequence of differences between states’ tax laws.

Fiscal Impact

- $3 million annually.

Impact on Taxpayers

- Businesses that have ‘nowhere income’ would be taxed on that income.

Impact on Competitive Position vs. Other States

- Minimal. Twenty-five other states have similar laws.

Business Taxes (Continued)

Proposal: Assess license tax on all business entities.

- For many years, the corporation was the only business entity that afforded limited legal liability protection for owners. A license tax was assessed on corporations.
- With the advent of 'limited liability entities' (LLP, LLC, etc.), a business could have limited liability but elect to be taxed as a partnership and avoid the license tax.
- As the license tax is a tax for the privilege of operating a business in Kentucky (and thus enjoying legal protection), it is logical that it should apply to all such businesses.

Fiscal Impact

- $29.9 million in FY05, $31.3 million in FY06.

Impact on Taxpayers

- Businesses that have organized or re-organized as non-corporate entities would become subject to the license tax.

Impact on Competitive Position vs. Other States

- Most states assess license tax on business entities, regardless of legal structure.

Business Taxes (Continued)

Proposal: Permit "investment in subsidiaries" as a deduction and allow consolidated corporate license tax returns (ITW).

- Multi-entity businesses may have the same capital subjected to license tax multiple times.
- A limited exemption from this inequity was created for Kentucky based corporations, but the exemption was overturned by the courts *(Illinois Tool Works)* because it was limited only to businesses that are 'headquartered' in Kentucky.
- This exclusion should be extended to all multi-entity businesses that meet common ownership requirements.

Fiscal Impact

- ($60.3) million in FY05, ($54.2) million in FY06.

Impact on Taxpayers

- Businesses that are multi-layered (parent/subsidiary) would not be subject to multiple assessment of tax on the same taxable capital.

Impact on Competitive Position vs. Other States

- This would increase competitiveness. Most other states that have a license tax allow an exclusion for common capital ownership within parent-subsidiary businesses.

Business Taxes (Continued)

Proposal: Lower Top Marginal Corporate Income Tax Rate.

- Corporate income above $250,000 earned in Kentucky would be taxed at 7.25 percent rather than the current rate of 8.25 percent.

Fiscal Impact

- A reduction of one-percentage point in the tax rate would lower corporate income tax receipts by $34.3 million in FY05. No behavioral responses are included in this estimate.

- If Kentucky is perceived as a more business-friendly state as a consequence, some additional economic activity may ensue, leading to renewed growth in revenues over the long run.

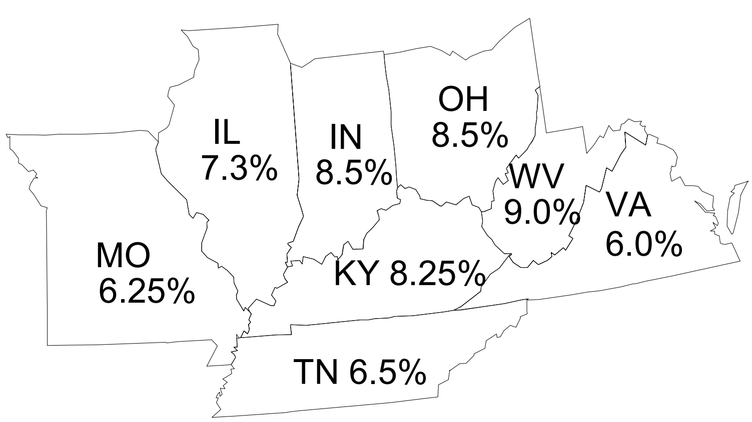
Impact on Taxpayers

- Corporate taxpayers would benefit from lower taxes on their Kentucky incomes.

Impact on Competitive Position vs. Other States

- A reduction in the top rate would lower Kentucky's top rate from the third-highest to the fifth-highest among the contiguous states, only above Missouri, Tennessee, and Virginia.

Top Corporate Income Tax Rates in Kentucky and Surrounding States



Business Taxes (Continued)

Proposal: Reform Enterprise Zone Program

- Prohibit further expansion of the zones beyond the borders that existed on December 31, 2002.

- Limit tax benefits exclusively to sales and use tax (eliminate Motor Vehicle Usage and corporate income tax credits)

- Apply benefits exclusively to qualified businesses.

- Redefine "existing business" to mean a business engaged in the active conduct of trade or business prior to the date of certification by KEDFA.

- Eliminate targeted workforce requirements.

- Extend the life of the existing zones by 10 years beyond the effective date of the new legislation (Jan. 1, 2004).

- KEDFA shall certify capital investment projects for existing businesses
  - Projects can receive tax credits for up to three years. Business and KEDFA shall agree up front to a three-year project cost.
  - Cap credits at $2 million per project

Fiscal Impact

FY04: $10.0 Million increase
FY05: $17.2 Million decrease
FY06: $26.2 Million decrease

Impact on Taxpayers

- Business taxpayers receive an extension of enterprise zone sales and use tax credits.

- A few businesses would receive smaller tax credits than they would under an extension of the existing program as a result of the $2M cap.

- Businesses will lose motor vehicle usage tax and income tax credits.

Impact on Competitive Position vs. Other States

- Improves competitive position by extending availability of business tax credits

Individual Income Tax

Proposal: Expand Low Income Credit (LIC) based on federal poverty guidelines (FPG). Amend low-income credit to apply to federal adjusted gross income. Additional relief would be provided to family units making more than 100 percent of FPG and the tax reduction would phase out at 123 percent of FPG for a family of one and at 164 percent of FPG for a family of four or more.

- Eliminates tax on families with federal adjusted gross income (FAGI) at or below 100 percent of the federal poverty level.
- To be eligible for the targeted relief, the taxpayer must maintain a household, may not be a dependent of another taxpayer, and must file a joint return if married.
- By using FAGI to compute the amount of the credit, the unintended benefits of the current low income credit to upper-income retirees and others with tax-exempt income are avoided.
- Those taxpayers with other states' municipal bond interest and lump-sum pension distributions eligible for ten-year averaging will have to compute a modified gross income. All other taxpayers will use the federal adjusted gross income from the Kentucky return.

Fiscal Impact

- The expansion of the lower income credit is expected to cost the General Fund an estimated $33.2 million in FY05 and $35.6 million in FY06.

Impact on Taxpayers

- Low-income taxpayers who currently do not qualify for the credit will have their tax liability reduced. A qualifying taxpayer at the federal poverty level in 2001 will have his current tax liability of $596 erased by the expansion of the credit.

- Nearly 178,000 individuals will be relieved of their existing income tax burden. Another 87,000 will have their taxes reduced.

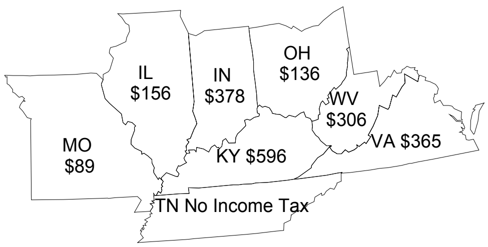
- Upper-income taxpayers who currently qualify for low income tax credit because of exempt income will no longer qualify.

- This does not penalize families for small increases of income by taking away the all of the benefit. Individuals and families that succeed in rising above poverty level income will owe some tax. However, the transition is relatively painless as the benefit is phased out.

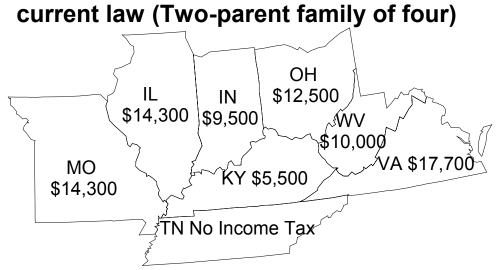
Impact on Competitive Position vs. Other States

- Kentucky's combined state and local income taxes in 1999 were the second-highest of all our surrounding states. Lowering our tax on these taxpayers to zero would make Kentucky the lowest (along with Missouri and Tennessee).

State Income Taxes on a Family of Four at
Federal Poverty Level ($18,104), 2001



Individual Income Tax Threshold, 2001
Level at which families begin owing tax under current law (Two-parent family of four)



Individual Income Tax (Continued)

Proposal: Phase-Out Pension Exclusion for Taxpayers Whose Federal Adjusted Gross Income Exceeds $40,200

- Taxpayers are able to exclude for the 2003 tax year $39,400 of pension income, regardless of source, age, or whether or not retired. The exclusion is indexed annually under KRS 141.0105 and is set at $40,200 for 2004.

- The cap would be reduced dollar-for-dollar by any income over the threshold. Exclusion would be eliminated for taxpayers with incomes of $80,400 or over (in 2004).

Fiscal Impact

- Freezing the exclusion level at the 2004 level will increase revenues by an estimated $78.7 million in FY05, and will increase the long-term elasticity of General Fund revenue.

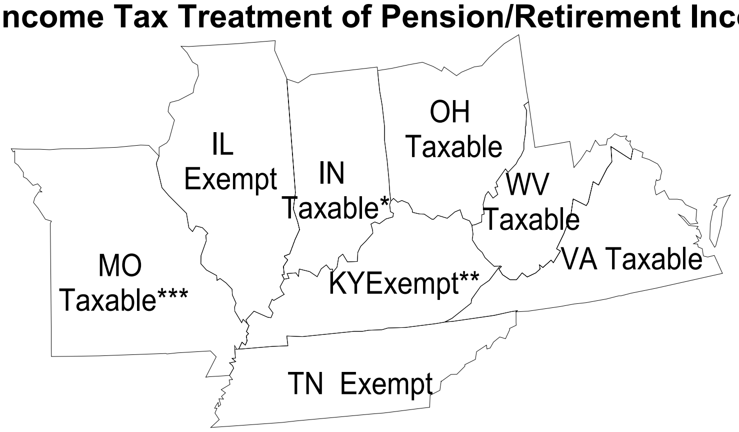
Impact on Taxpayers

- Taxpayers with pension benefits above the current pension exclusion will pay additional tax. Approximately 100,000 taxpayers with retirement income would be affected.

Impact on Competitive Position vs. Other States

- Most states surrounding Kentucky tax pensions like other income or offer limited exclusions.

State Income Tax Treatment of Pension/Retirement Income



*Small exclusion for federal/military pension income.
** Pension exclusion limited/tied to inflation rate.
***First $6,000 excluded from taxation.
Source: Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States*, January, 2001.

Individual Income Tax (Continued)

Proposal: Codify Eliminating the Deduction of Income Tax Paid to Foreign Governments

- In 1990, the Kentucky General Assembly removed the deduction for income taxes paid to the federal government. By an oversight, it failed to also remove the tax deduction for taxes paid to foreign governments. In the 2003 General Assembly, a measure attached to the budget bill removes the deduction. However, at the end of the current biennium, the deduction will once again become allowable.

Fiscal Impact

- The elimination of this deduction is expected to yield $3.5 million in its first year of implementation.

Impact on Taxpayers

- Relatively few taxpayers would be affected.

Impact on Competitive Position vs. Other States

- This measure might lead taxpayers who currently avail of the deduction to consider changing their state of residence to a state where the deduction is allowed or a state with no personal income tax. It is not expected to affect the desirability of Kentucky residences significantly.

Property Tax

Proposal: Eliminate Kentucky's state property tax on motor vehicles and watercraft, retain $3.00 fee for administrative purposes, effective January 1, 2005.

- $3.00 fee would cover cost of maintaining records for the benefit of local taxing jurisdictions, and to cover county clerks' commissions.

Fiscal Impact

- The estimated impact of eliminating the motor vehicle and watercraft property tax would be -$47.8 million in its first year of implementation (FY05), and would rise to -$102.9 million in FY06. This impact is offset by $4.2 million in FY05 and $8.5 million in FY06 due to the $3.00 fee.

Impact on Taxpayers

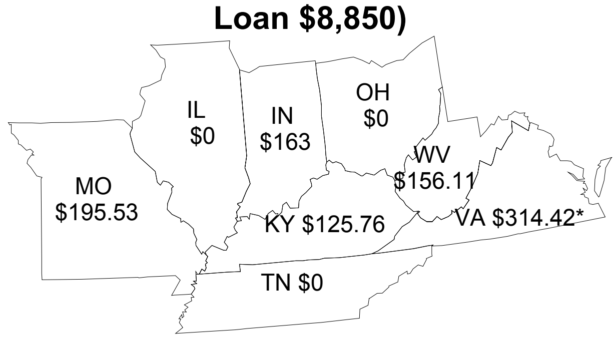
- The tax is considered to be regressive and harmful to the working poor, who must maintain vehicles in order to have transportation to work.
- This tax has proven to be very unpopular, and in the referendum on the issue in 1998 voters overwhelmingly approved a constitutional amendment allowing the state to exempt motor vehicles from property taxation.
- Taxpayers will continue to owe local property taxes on their motor vehicles and watercraft.
- The owner of a typical automobile with a trade-in value of $9,825 would see his total state and local property tax on that vehicle fall by $41.21.

Impact on Competitive Position vs. Other States

- Property taxation of motor vehicles and boats varies tremendously among the states. Several states bordering Kentucky exempt these items of property from taxation.

- Only five states have a property tax at the state level. Kentucky's tax rate of 45 cents per $100 is the highest of any state.

Typical State and Local Property Tax Burden on 1996 Ford Taurus (May 1999 NADA values: Retail $11,850, Trade-in $9,825, Loan $8,850)



Property Tax (continued)

Proposal: Amend KRS 132.020 to freeze the state rate on real estate at 13.3¢ per $100 of value, or amend statute to exclude the value of new property in rate-setting calculations, effective January 1, 2004.

- The state property tax rate on real property has declined steadily from 1979 to the present as a result of the enactment of changes to KRS 132.020. These provisions limit the state to a four percent increase per year in real property tax revenues. The rate was 31.5 cents per $100 of assessed value in 1978 and has decreased to 13.3 cents per $100 of assessed value for 2003.

- The exclusion of newly-constructed property from the base would conform the state to rules governing calculations of local property tax rates.

Fiscal Impact

- The revised annual rate setting procedure would halt the 24 year decline of the state real property tax rate, resulting in a net gain for the general fund of $3.4 million in FY 2005, $7.2 million in FY 2006, and growing proportionately thereafter. No local revenue impact would occur.

- Very similar revenue impacts would result from excluding new property from rate-setting calculations.

Impact on Taxpayers

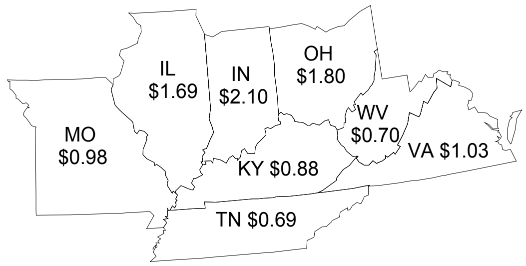
- The owner of a $100,000 residence in Kentucky would pay about $3.00 more in property taxes in 2005 if the real property tax rate is frozen at 13.3¢/$100. The state portion of the tax bill would be $133 versus $130. The total property tax bill, based on the 2002 average county, city and school district tax rates, would be $1,032 versus $1,029.

Impact on Competitive Position vs. Other States

- Kentucky's real property tax rate at the state level remains relatively high compared to surrounding states. However, comparing the state and local tax burden combined shows Kentucky to be competitive with other states.

- The study "Tax Rates and Tax Burdens in the District of Columbia—A Nationwide Comparison", performed by the Office of the Chief Financial Officer of the District of Columbia (2000), ranked Kentucky 31st of all fifty states and the district in residential real property tax rates.

Tax Rates on Residential Real Property
(Per $100 of full value)



Source: Barents Group, *Comparative Analysis of Kentucky's Tax Structure*, December 1999.
Note: property tax rates are based on a representative locality within each state.

Property Tax (continued)

Proposal: Exempt Intangible Personal Property from State Taxes, effective January 1, 2004.

- The intangible property tax currently applies to a variety of items remaining after the St. Ledger court case ended the taxation of stocks and stock related items (e.g., mutual funds) in 1997. This tax, all of which is state revenue, now applies primarily to businesses and business activities, and some individuals. The tax remains on Money Market Accounts, Bonds, Loans, Notes, Mortgage Receivable, Land Contracts, Trusts, Cash, Deposits, Accounts Receivable and other types of intangible personal property. Approximately 61 percent of the tax revenues are from the tax on business accounts receivable.

- The "Franchise Value" under KRS 136.120 is considered to be an intangible and should remain taxable.

Fiscal Impact

- This proposal would involve a loss of approximately $34.7 million in FY05 and $36.3 million in FY06. No local revenue impact would be involved.

Impact on Taxpayers

- This proposal would relieve over 43,000 taxpayers from the necessity of filing intangible property tax returns.

Impact on Competitiveness vs. Other States

- Elimination of the intangible property tax may enhance Kentucky's competitiveness with regard to business location decisions.
- This proposal would minimize or offset the impact of any other tax reform proposals that may adversely impact upper income Kentuckians, or businesses.

Property Taxation of Intangible Personal Property

Sales Tax

Proposal: Require affiliates of businesses with nexus in Kentucky to collect sales and use taxes on their remote sales into the state.

- This proposal will dovetail with the Streamlined Sales Tax Agreement, which will make it relatively easy for remote vendors to collect states' sales taxes. Under that agreement, several Dot.com affiliates have offered to begin collecting sales taxes.

Fiscal Impact

- Because of uncertainty regarding compliance and enforcement, revenue estimates assume little revenue initially, rising with time as knowledge of this initiative spreads. It is estimated to yield $6 million the first year and $7 million the next.

Impact on Taxpayers

- Imposition of a sales tax on remote vendors that are affiliates of businesses with Kentucky nexus will raise the prices of their goods relative to other vendors. Consumers who buy from these vendors may expect to pay more unless the remote vendor offsets the sales tax through a price reduction. This is unlikely if Kentucky is the only state enforcing this provision.

Impact on Competitiveness vs. Other States

- This proposal should strengthen the competitiveness of Kentucky businesses currently subjected to sales competition from remote vendors who are avoiding their responsibility to collect and remit the state sales tax.

Sales Tax (continued)

Proposal: Codify a requirement that local distribution companies charge tax on the natural gas distribution, transmission or transportation services whether or not they are rendered as part of the sale of the gas.

- Tax will be levied on the entire charge of the gas including the distribution, transmission and transportation charges no matter if it is purchased in or out of the state.

- This provision was included in HB 269, the budget bill, but will expire at the end of FY04 unless action is taken to make it permanent.

Fiscal Impact

- Failure to enact this proposal will cost the state an estimated $6.0 million in FY05.

Impact on Taxpayers

- Taxpayers subject to this will begin paying sales tax on distribution of natural gas beginning in FY04. Extending the treatment beyond that year will have no impact on them.

- There is currently an exemption for energy and energy-producing fuels used in the course of manufacturing, processing, mining, or refining to the extent that the cost of the fuels used exceeds 3% of the cost of production. Therefore, manufacturers who are heavy users of energy should not be adversely affected by this change.

- Current law provides an exemption for fuel used for residential heating, water heating, cooking, lighting and other residential uses. The proposed language also exempts the distribution and transportation services provided to Kentucky residents for residential use.

Impact on Competitive Position vs. Other States

- This proposal should improve the competitive position of in-state suppliers of natural gas, who will now be on an equal footing tax-wise with out-of-state competitors.

Sales Tax (continued)

Proposal: Extend limit on vendor compensation at $1,500 per reporting period

- Under existing statute, retailers may reimburse themselves for the cost of collecting and remitting the sales tax by deducting 1.75 percent of the first $1,000 of tax due and one percent of the tax due in excess of $1,000. This statute was superceded by language in HB 269 (the budget bill) that limited compensation to $1,500 per retailer per month.

Fiscal Impact

- Extending the cap imposed by HB 269 would yield approximately $7.1 million in FY05. Growth would be the same as overall growth for sales taxes.

Impact on Taxpayers

- Based on information from the Revenue Cabinet, relatively few (about 120) retailers would be affected.

Impact on Competitiveness vs. Other States

- This measure would put large Kentucky retailers at a small disadvantage to those state offering compensation.

Sales Tax (continued)

Proposal: Apply the sales and use tax to selected discretionary services that have been previously excluded from the tax.

- Services recommended for taxation:

Services recommended for taxation	(million $)
Laundry and Dry Cleaning	16.2
Janitorial Services	18.8
Exterminating & Pest Control	3.9
Participatory Admissions Fees (golf, bowling, skating, amusement park rides)	8.5
Car Washes	3.6

Fiscal Impact

- It is estimated that the taxation of the above-named services would yield $51.0 million in FY05.

Impact on Taxpayers

- Obviously, taxpayers will be affected to the extent that they purchase any of the identified services. Businesses will be more affected by the tax on janitorial services, while businesses and individuals alike will be affected by taxing dry cleaning and car washes. It is expected that individuals will bear most of the tax on participatory admission fees.

Impact on Competitiveness vs. Other States

- Indiana, Illinois, and Virginia impose sales taxes on none of the proposed services.
- Missouri, Tennessee, and West Virginia tax most of the proposed services.

Sales Taxation of Services By State

(X = service is taxed)

Type of Service	IL	IN	KY	MO	OH	TN	VA	WV
Janitorial services					X			X
Exterminating services					X			X
Dry cleaning and laundry						X		X
Personal instruction (dance, golf, etc.)								X
Car washing					X	X		X
Amusement park rides			X	X		X		X
Billiard Parlors				X		X		X
Bowling Alleys				X		X		X
Coin-operated video games				X				X
Pinball and other mech. Amusements				X				X

Source: Federation of Tax Administrators, *State Taxation on Services, 1996 Update*

Sales Tax (continued)

Proposal: Raise the sales tax rate 1 percent to 7 percent and allow limited electronic gaming devices (EGDs) in Kentucky. EGD revenues for the first two years will be dedicated to the Budget Reserve Trust Fund. After two years, sales tax rate will drop back to 6 percent and EGD revenues will accrue to the General Fund.

- Two years are needed to get EGDs fully operational. Any revenues earned in that period should be dedicated to the state's "Rainy Day" Fund. After two years the sales tax rate would be reduced permanently to 6 percent, and future EGD revenues would be treated the same as any other General Fund revenue.

Fiscal Impact

- A sales tax increase of 1.0 percentage point would yield $416.2 million in FY05.

- Estimated gaming revenue from HB 537 as considered by the 2003 General Assembly would be $194.2 million annually in revenue at full implementation.

Impact on Taxpayers

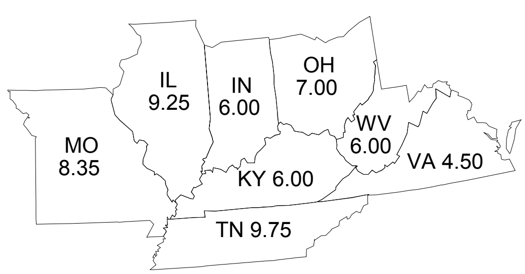
- Based on information from the 1999 Barents report on Kentucky's tax system, an increase of 1 percentage point in the sales tax rate would cost a family of four with annual income of $30,000 a total of $81.84 annually in additional sales taxes.

- Effective tax rates and incidences of revenue from gaming cannot be estimated due to factors that would be controlled by the operators of gaming devices.

Impact on Competitiveness vs. Other States

- In 2001-2002, Missouri and Illinois raised local sales tax rates; Indiana and Tennessee raised their state sales tax rate.

Sales Tax Rates in States Surrounding Kentucky
(Percent, maximum state and local rate)



Source: Federation of Tax Administrators

- In recent years, legalized casino gambling has expanded into Illinois, Indiana, West Virginia, and Missouri. Tennessee has legalized but not yet implemented a state lottery. The expansion of gaming opportunities has led directly to reduced collections at Kentucky racetracks.

- Expanded gaming opportunities in Kentucky will reduce the flow of dollars out of state from Kentuckians who wish to engage in gambling activities.

Sales Tax (continued)

Proposal: Eliminate the sales tax on 'switch access' fees charged between telecommunications providers.

- This proposal is considered a fairness issue. Switch access fees are part of the cost of the end product of telecommunications companies. If this were a tangible good, it would be exempted from sales tax because it is not sold to a final consumer, rather it becomes a part of the end product that is taxed when sold. But the related sales tax exemption applies only to tangible property, not to services such as switch access fees. Extending this exemption is consistent with the way tangible goods are taxed.

Fiscal Impact

- ($26.7) million in FY05, ($27.0) million in FY06.

Impact on Taxpayers

- The removal of switch access fees from sales tax will place telecommunications providers on equal footing. Currently most, but not all, telecommunications providers are subject to this tax.

Impact on Competitiveness vs. Other States

- This proposal would not have a significant impact on competitiveness as compared to other states.

Sales Tax (continued)

Proposal: Assess sales tax on Direct Broadcast Satellite (DBS) services.

- Direct Broadcast Satellite service is provided primarily by out-of-state vendors. DBS competes against cable and other providers who are located in Kentucky and pay property and other taxes within this state. Assessing sales tax on DBS services will provide some revenue from a source that currently is not taxed, but competes against providers that are subject to some level of tax within Kentucky.

Fiscal Impact

- At 7% proposed rate, $17.4 million in FY05, and $18.1 million in FY06. (At 6% rate, $14.9 million in FY05, and $15.5 million in FY06.)

Impact on Taxpayers

- Current and future DBS subscribers will pay more for services provided.

- Other competing service providers will be placed on a more level footing.

Impact on Competitive Position vs. Other States

- This proposal should not have a significant impact on Kentucky's competitive position. The tax is assessed on services delivered to Kentuckians, regardless of the point of origination.

Note: This proposal assumes a rate of tax equal to the state sales tax rate. If some other rate is used, the tax must be structured as an excise tax, and not as a sales tax, in order to be in compliance with the Streamlined Sales Tax Agreement.

Tobacco Taxes

Proposal: Raise the excise tax on cigarettes to 55 cents/pack, impose a 13 percent excise tax on other tobacco products, and limit wholesalers' compensation for affixing cigarette tax stamps.

- To prevent mass hoarding of cigarettes in warehouses for the months prior to the rate change, a floor stock tax should be levied on cigarettes on warehouse shelves prior to the effective date of the change. The tax should equal the difference between the old tax (3 cents) and the new rate.

  Wholesalers are entitled under existing statute to be compensated an amount equal to 30 cents face value for each $3 of tax evidence purchased at face value, or a discount of 9.09 percent. This discount was reduced by half in the FY03-04 budget.

Fiscal Impact

- An increase to 55 cents/pack would raise $208.6 million.
- The excise tax on other tobacco products is estimated to yield $7.6 million in its first year.
- Loss of sales to border states would be slightly less than earlier estimated due to recent tax increases in those states.
- Sales tax revenues would suffer by $8.7 million due to lower cigarette sales volume. (This has already been factored into the estimate stated above.)
- Cigarette tax revenues would increase by about $900,000 by freezing vendor compensation. (This assumes that the cigarette tax increase comes in the form of a surtax, rather than an increase in the existing cigarette tax rate.)

Impact on Taxpayers

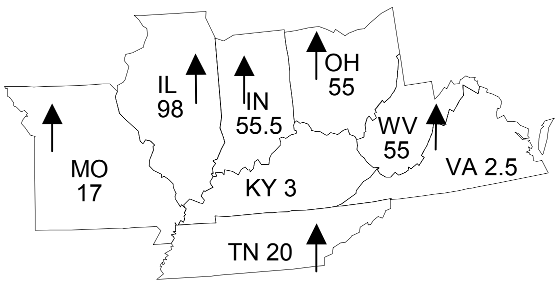
- A pack-a-day smoker would pay an additional $189.80 in cigarette taxes annually.

Impact on Competitive Position vs. Other States

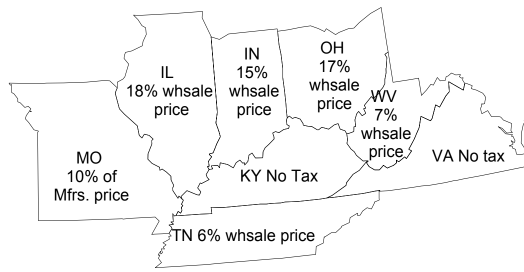
- The average cigarette tax nationally is 69 cents/pack.
- Five of Kentucky's seven surrounding states have raised their cigarette tax in the past year. West Virginia and Missouri are considering increases this year.
- The average cigarette tax rate of states surrounding Kentucky, minus Virginia and Tennessee, is 56 cents/pack.
  Other southern state averages (cents/pack): AL--16.5, AR--34, GA--12, MS--18, NC--5, SC--7

Cigarette Excise Tax Rates in Surrounding States

(cents per pack)



State Taxes on Other Tobacco Products (pipe tobacco, cigars, snuff, chewing tobacco, etc.)



Alcoholic Beverage Excise Taxes

Objective: Simplify and streamline Kentucky's taxation of alcoholic beverages, and eliminate taxes that are overly burdensome on industry and difficult to administer.

- Taxes on alcohol in Kentucky include:

  Distilled spirits consumption tax
  Beer consumption tax
  Wine consumption tax
  Distilled spirits wholesale tax
  Beer wholesale tax
  Wine wholesale tax
  Distilled spirits case sales tax

- Of these taxes, the beer wholesale tax is by far the largest source of revenue.

Proposal: Eliminate the distilled spirits, wine, and beer consumption taxes as well as the distilled spirits case sales tax and replace the lost revenue by slightly increasing the wholesale tax on beer, wine, and distilled spirits.

- Current wholesale tax rates are 9 percent for beer, wine, and distilled spirits. This proposal raises the rate to 14 percent for distilled spirits, 11.6 percent for wine, and 10.75 percent for beer.

Fiscal Impact

- This proposal is designed to be revenue neutral.

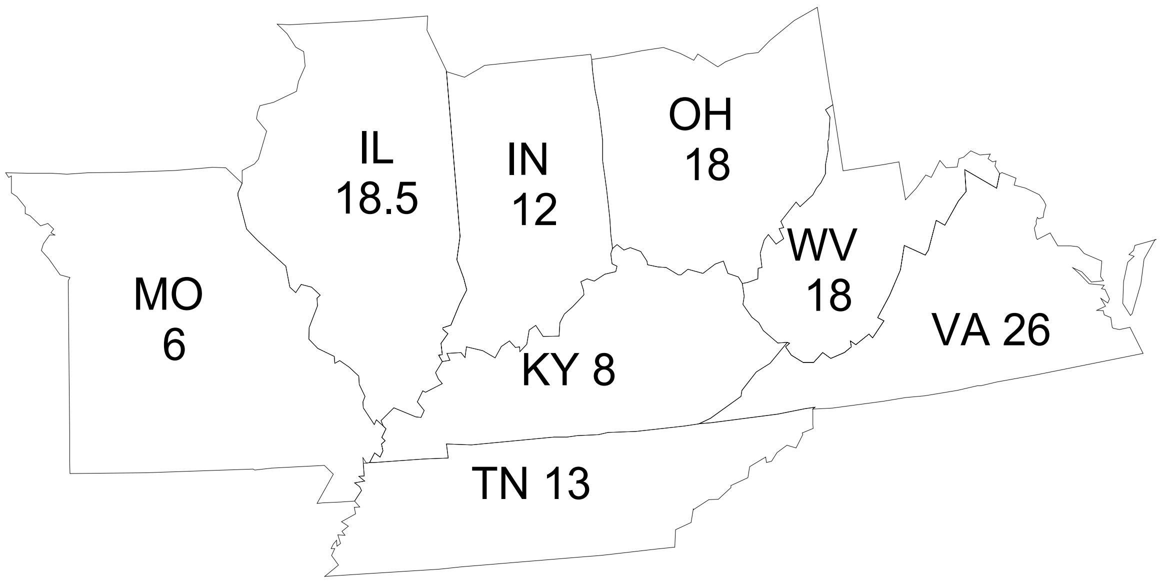
Impact on Taxpayers

- Compliance should be easier for distillers, vintners, brewers, wholesalers and retailers of alcoholic beverages. Overall levels of taxation should not change on the industry or on consumers.

Impact on Competitiveness vs. Other States

- This proposal should not have a competitive impact in that it does not change the level of taxation. It does ease business for the industries affected.

Beer Excise Tax Rates in Kentucky and Surrounding States
(cents per gallon)



Source: Federation of Tax Administrators